

UNIT-2

INTERNAL CONTROL

Meaning of Internal Control

Internal control implies the whole system of control employed by the management in order to carry on the business of the enterprise in an orderly and efficient way by having an automatic check and balance over all the transactions. It includes internal check, internal audit and other devices of control. Internal control system assures the management that the information it receives is both reliable and accurate. The system also helps to ensure that assets are secure and management policy is being followed properly. Its efficient working not only guarantees management as to the reliability of accounting information, independent auditors also rely on system of internal control in determining the timing, nature, and extent of their audit work.

Internal control is necessary for the successful working of any types of business organisation. A good internal control is necessary for the management to obtain important information and to get control and protection over the affairs of the firms. A system of internal control may vary from one business to another business based on its ownership.

Definition of Internal Control

According to W.W. Bigg, "Internal control is best regarded as indicating the whole system of controls, financial and otherwise, established by the management in the conduct of a business, including internal check, internal audit and other forms of control".

Features of Internal Control

The features of internal control are as follows:

1. **Control environment** - The control environment includes the integrity, ethical values, and competence of the entity's people and is the foundation for all other components of internal control.
2. **Risk assessment** - Every entity faces risks that must be identified, analyzed, and managed to achieve its objectives.
3. **Control activities** - Control activities are the measures used to help ensure

4. that management directives are carried out and that risks are addressed. They take many forms including policies and procedures, approvals, verifications, reconciliations, performance reviews, security measures, and segregation of duties.
5. **Information and communication** - Information systems must be in place to identify, capture, and communicate relevant information in a form and timeframe that enables people to carry out their responsibilities and maintain accountability for the entity's assets.
6. **Monitoring** - The entire internal control process must be monitored and the quality of its performance assessed as a part of regular management and supervisory activities. Corrective actions must be taken whenever the system does not perform as intended.

Objectives and Advantages of Internal Control

An internal control system comprises the whole network of systems established in an organisation to provide reasonable assurance that organisational objectives will be achieved.

The general objectives/advantages of internal control are as follows:

1. **Orderly and Efficient Conduct of Business:** To ensure the orderly and efficient conduct of business in respect of systems being in place and fully implemented. Controls mean that business processes and transactions take place without disruption with less risk or disturbance and this, in turn, adds value and creates shareholder value.
2. **To Safeguard the Assets of the Business:** Assets include tangibles and intangibles, and controls are necessary to ensure they are optimally utilised and protected from misuse, fraud, misappropriation or theft.
3. **To Prevent and Detect Fraud:** Controls are necessary to show up any operational or financial disagreements that might be the result of theft or fraud. This might include off-balance sheet financing or the use of unauthorised accounting policies, inventory controls, use of company property and similar.
4. **To Ensure the Completeness and Accuracy of Accounting Records:** Ensuring that all accounting transactions are fully and accurately recorded, that assets and liabilities are correctly identified and valued, and that all costs and revenues can be fully accounted for.
5. **To Ensure the Timely Preparation of Financial Information:** Which applies to statutory reporting (e.g., of year end accounts) and (also management accounts, if appropriate, for the facilitation of effective management decision-making).

6. **Implement Management Policies:** Internal control helps to implement management policies to attain corporate goals.
7. **Detects Errors and Frauds:** Internal control helps the auditor in his/her work detecting all the errors and frauds which are committed in the books of accounts.
8. **Increases the Accuracy and Reliability:** Internal control helps to increase the accuracy and reliability of financial statement and books of accounts.
9. **Regulate the Work of Staffs:** Internal control helps to regulate the work of staffs through division of work among the staffs in a scientific manner which helps to make the daily works of staffs effective.
10. **Helps to Prepare Plans:** Internal control helps the management to prepare and implement effective plans by providing correct and factual information.
11. **Boost Morale of Employees:** Internal control helps to put morale pressure on staffs.

Disadvantages of Internal Control

Internal control system has the following inherent limitations:

1. **Organizational Structure:** Deficiencies in the organizational structures makes the internal control ineffective.
2. **Expensive:** A key disadvantage of internal controls is that they are expensive, and therefore may not be worth putting into place, as the continual use of the control is more expensive than the cost of the risk arising. This is a matter of judgement for the directors and often determines the structure and level of internal controls that are put into place in business.
3. **Human Error:** Potential for human error in the operation of internal control due to carelessness, distraction, mistakes of judgement and the misunderstanding of instructions.
4. **Overridden of responsibilities:** Possibility of control being by-passed due to collision of two or more persons, whether inside or outside the entity. Possibility that a person responsible for exercising an internal control could abuse that responsibility by overriding and internal control.
5. **Frequent Follow Up measures:** Frequent follow up procedures need to be undertaken frequently to ensure its effectiveness which is extremely time consuming.

INTERNAL CHECK

Internal Check is an accounting procedure whereby routine entries for transactions are handled by more than one employee in such a manner that work formed by one performed staff member / employee is automatically checked by another staff member/employee for detection errors and irregularities, if internal check as done chances of or fraud is least

An internal check is a continuous process of the accounting system to check for errors or fraud in bookkeeping operations for early detection and prevention. The internal check is an arrangement of the duties of the staff members of the accounting functions in such a way that another automatically checks the work performed by a person.

An internal check is a continuous process and part of the daily routine. It relates to all the transactions that take place every day. An internal check is achieved by a complimentary allocation of duties and by independent verification of the work of one person by another.

Definition:

According to Spicer and Pegler, "A system of internal check is an arrangement of staff duties, whereby no one person is allowed to carry through and to record every aspect of a transaction so that without collusion between two or more persons, fraud is activated and at the same time the possibilities of errors are reduced to the minimum."

According to F.R.M. De PAULA, "Internal check means practically a continuous internal audit carried on by the staff itself, by means of which the work of each individual is independently checked by other members of the staff."

Objectives of Internal Check

The following are the objectives of internal check:

1. **To Detect and Prevent the Errors and Frauds:** The duties of the staff are arranged in such a manner that the performance of each individual in an organisation, normally and automatically, is checked by another. Therefore, the chances of occurrence of errors and frauds are very less. Internal check helps in early detection of errors and frauds.
2. **To Fix up the Responsibility of Each Staff Members:** The division of responsibility is made in such a way that the chances of errors and frauds are less. The responsibilities are fixed up on a broad principle.
3. **To Prevent Misappropriation of Goods and Cash:** The duties and responsibilities are divided in such a way that no single person has

excess to carry out a transaction completely. For example, persons having physical custody of assets should not have access to the books of account. Also, apart from accounting control, periodically, the physical and financial records of important assets should be reconciled. This prevents misappropriation of goods and cash

4. **To Exercise Morale Check on the Staff Members:** As the work is carried- out by different persons there will be morale check on each other.
5. **To Expedite the Work of the Staff Members:** The principle of division of work may lead to specialisation. This will expedite the work.
6. **To Simplify the Work of the Auditor:** The auditor can rely on it and on that consideration, reduce the extent of detailed checking to be carried-out by him provided he has checked its effectiveness by the of procedural tests. It helps the auditor to prepare the final accounts on time.
7. **To Increase Production:** The production can be increased by the way of increasing the efficiency of the staff members.
8. To ensure an accurate recording of all the business transactions.

Features of Internal Check

Certain qualities are needed to make an internal check more effective and efficient. Such qualities are known as features of internal check system which are as follows:

1. **Division of Work:** Before applying test check it is necessary to divide the entire tasks among the staffs in such a way so that work can be checked automatically by another staff. Like, when staff takes the responsibility of purchase, then another staff should make its payment.
2. **Provision of Check:** An organisation should set-up such provision, so that work can be checked by another staff. An officer can check the work of one staff by transferring to the other staffs again.
3. **Use of Devices:** In this modern world, various devices can be used to do various function like use of time record machine, wage determination machine, etc. An organisation should use such machines which help to make work of internal check easier.
4. **Self-Balancing System:** An organisation can use self-balancing ledger accounts which helps to make the work of internal check easier. Its effectiveness depends on its management.
5. **Change in Work:** An organisation needs to transfer the staffs from one place to another place so that the work of previous staffs can be

checked by the later staffs which help to make the internal check system effective.

6. **Specialisation:** Every staff may not have such specialised knowledge to maintain accounts properly. So, an organisation should give training to increase their skill so that internal check can be made more productive.
7. **Control:** There is more chance of frauds where there is direct contact of consumer or public. So, a manager can keep eyes on those works so that internal check system can be made more worthwhile.

Principles of Internal Check

1. **Sufficient Staff:** The principle of internal check is sufficient staff. The employees can be appointed according to the workload. The management can determine the amount of work, which is distributed among the departments. The persons are hired to perform their duties. The overloading can create trouble for management.
2. **Division of Work:** Division of work is a principle of internal check. The management can determine the total amount of work. The whole work is divided among departments. The heads of such department are responsible for completion of work according to timetable.
3. **Co-Ordination:** Coordination is a principle of internal check. All departmental managers are bound to coordinate with other in order to achieve organization objectives. When there is fault in one department, the work of another department suffers. The objectives cannot be achieved. Internal check determines the degree of coordination among the managers.
4. **Rotation of Duties:** Rotation of duties is a principle of internal check. The workers feel bored by doing the same work from year to year. There is a need of rotation of duties. It is in the interest of concern as well as employees. The efficiency is improved due to changes in duties.
5. **Recreation Leave:** The recreation leave is a principle of internal check. The employee can check recreation leave. It is necessary for mental health. He can commit fraud as the new employee in his place can disclose the matter. The internal check system can work in the interest of business. The weakness of one person is disclosed due to leave.
6. **Responsibility:** The responsibility is a principle of internal check. The employee can enjoy recreation leave. It is necessary for mental health. He can enjoy recreation leave. It is necessary for mental health. He cannot commit fraud as the new employee in his place can disclose the matter. The internal check system can work in the interest of business. The weakness of one person is disclosed due to leave.

7. **Automatic Machines:** The principles of internal check are that machines must be used to do accounting work if permissible. The machines can do a lot of work without delay. The chances of fraud and error are reduced to a minimum. The working of machines improves the efficiency of accounting staff.
8. **Checking:** The principle of internal check is to check the work of other employees. Many persons perform the work. The officers can put their signatures to verify the work done by their subordinate. In this way one work passes many hands. The chances of error and fraud are minimized due to checking and counter checking.
9. **Simple:** The principle of internal check is simple in working. The employees can understand the working of the internal check system. A person can work under the supervision of other employees. The line of authority moves from top to bottom level. All workers can understand their duties in the organization.
10. **Documents Classification:** The classification of documents is the principle of internal check. The business documents are prepared, collected, recorded and placed in proper files. The index is prepared to compile the data. The filing system is useful to place the latter. In case of need the documents are traced at once.
11. **Dependent Work:** Dependent work is a principle of internal check. The work of one employee is dependent upon others. One work passes in the hands of two or three persons till it is complete. Another person checks the work done by one person. No person is all in all to start and complete the transactions.
12. **Harmony:** The principles of internal check are harmony among the employees and departments. The understanding is essential for business goals. The management is to achieve other social and national objectives. The harmony is the basis for successful internal check.

Internal check as regards:

Internal checks- Wages

Wages are a very important item of expenditure. The system of internal check for wages should be devised in a planned and careful manner. There are great possibilities of frauds in a concern employing a large number of workers. A sound system of internal check in payment of wages may avoid errors and frauds which may be revealed from time and piece wages records.

The following system of internal check may be adopted as regards wages.

I. Maintenance of Wages Records

1. Time Records: It is a record maintained by the gate keeper who records the entry time and exit time of each worker. Foremen of each department also maintain records for time spent by an employee. When wages are paid on the basis of time spent by a worker, the record maintained by the gate keeper and record maintained by foremen of each department are summarised for payment of wages.

2. Piece-work Records: This record is maintained by the foremen who records the actual work done by each employee. Each person is provided a job card who records the work done by him. Finally, the record maintained by the foremen and job card are used in determining wages.

3. Overtime Records: Overtime should be sanctioned in advance by a responsible person. Employees should be issued overtime slips bearing the name and number of workers. Such slips should be issued and initialed by some responsible official. At the end of the week such slips should be sent to the wage office.

4. Pass-out Records: The workers should not be allowed to leave the factory without the written permission. For this, a pass-out slip is issued to the worker by same authority. Such slips are handed over to the gate keeper. The wage office should also be given copy of it.

II. Preparation of Wage Sheet:

The wage sheet should not be prepared by one clerk alone. A set of clerks should compare the records maintained at the gate and the wage office and enquire about differences, if any. The following points should be taken into account.

1. Base: The wage sheets should be prepared with the help of attendance register, overtime slip and pass-out slip.

2. Separate Sheets: Separate wage sheets should be used for time-workers and piece-workers.

3. Checking: The wage sheet should be inspected and counter signed as correct by the works manager and foreman.

4. Signature: The wage sheet should be counter signed by those employees who has prepared it.

5. Approval: Each and every wage sheet should be approved by factory manager or managing director.

III. Payment of Wages:

1. The person who is in-charge for payment of wages should not have connection with the preparation of wages sheet.
2. Each worker should be asked to receive his wages personally in the presence of his foreman to identify him.
3. No payment is made to someone on behalf of a worker who is absent.
4. Wage payment should be made by cash department, not by other persons.
5. The amount of wages for each employee should be placed in an envelope bearing the name and number of person.
6. Special arrangements should be made for payment to the absentees.
7. Exact amount of money should be drawn from the bank for payment of wages.
8. Advances to workers should be discouraged and if it becomes unavoidable, they should be given through the petty cashier.
9. If casual workers are also employed in the factory a separate record should be maintained about them.
10. Undisbursed wages should be deposited immediately into the bank.

Internal check as regards Cash Sales

Internal check as regards Cash Sales in a big business house, where a large number of daily cash transactions. There many chances of frauds and irregularities if there is no good system of internal check. There may be three types of cash sales-

- **Sales at counter,**
- **Sales by traveling agents, and**
- **Sales by Post.**

1. Cash Sales at counter:

The internal check system should consist of the following elements:

- I. For each counter, a separate salesmen should be appointed to look after his counter.
- II. Every salesman in charge of making sales should be allotted an identification number or a specific name.
- III. Cash sale invoices or cash memos should be pre numbered and be of different colours for different departments.

- IV. When the goods are sold to the customer the salesman at each counter should prepare pre numbered cash memos in triplicate,
- V. Two copies are handed over to the customer who carries them to the cashier. Cashier receives the cash and stamps them cash paid. Cashier returns one copy to the customer and the other copy is retained by the cashier. The goods sold are then handed over to the customer either by the cashier or by the salesman.
- VI. If goods are handed over to the customer by the gate keeper, four copies are required to be made by salesman. In such cases, one copy is retained by the gate keeper.
- VII. At the end of day, salesman's summary which reveals quantity and value of the goods sold should be tallied with cash sales summary prepared by the cashier and the gatekeeper's summary which reveals the goods delivered during the day.
- VIII. If any discrepancy is found, it implies that there are certain errors or frauds and those have to be removed the same day or the next day.
- IX. Daily cash receipts should be deposited in a bank on the same day and statement of cash sales of the day or cash sales summary should be sent to the accounts department.
- X. In some organizations, cash recording machines are used. In such cases, the total of cash received as shown by the machine, should be checked with the amount actually banked.
- XI. In some departmental stores, bar code stickers are struck on all products. The customer chooses the goods displayed and takes them to the cashier. A computerized title reads the bar code, and records the price automatically. The entry for the transaction also updates stock records. Cash collected can, thus, be easily reconciled with completely accurate sales figures.

2. Cash Sales by Traveling Agents:

In some business houses, traveling agents are appointed to make sale. In such a case, internal check system may be as follows-

- I. The agents authorized to sell goods for cash should issue a temporary receipt for the cash received and the customer should be instructed to get the receipt from the head office.
- II. The head office/branch office shall issue and mail a confirmed receipt to the customer within a stipulated period. If the customer does not receive the receipt within that period, he should enquire for the same from the head office.
- III. The agent should be instructed to remit the cash collected daily or periodically or deposit it into the bank account of as per instructions of

the head office without any deduction for salary or commission payable to him.

- IV. The head office should send the statement of accounts regularly to each individual customer to keep him informed about the amount due to him.
- V. The agent should also send. Account sales giving full details of sales made, cash collected and sent and expenses incurred to the head office.
- VI. To avoid any fraud every salesman should be replaced and transferred regularly to other areas.

3. Postal Sales:

In business houses where goods are sold by post, the system of internal check shall be-

- I. A separate sales register should be maintained for recording sales made by post or VPP. (Value payable post)
- II. Cash received and goods retained on this account should also be entered in this register.
- III. A responsible officer should be deputed to check carefully the VPP register and the goods for which cash has not been received should be especially audited.
- IV. In this connection cash received should be checked carefully from cash book.
- V. Orders received should be filed date wise and in serial order.
- VI. Cash received through postal sale should be deposited into bank separately.
- VII. Regular and careful checking of the sale and payment register should be done by an officer of the company.

INTERNAL CHECK AS REGARDS CASH PURCHASES

To impose proper control the purchase department should function separately and its work should be subdivided among small department that are headed by responsible officer.

So, the work connected by responsible department is divided in following heads:

1. **Requisition:** The procedure for issuing purchase requisitions should be specified. The head of the **department, who is in the need of goods**, should **fill in a requisition slip** duly signed and then should send it to the purchases department. The details about the quantity, quality and the time by which the goods must be supplied be clearly mentioned in the requisition slip.

- 2. Enquiry:** Purchase department must send letter of enquiry to suppliers asking to quote terms, rates, quality and delivery terms. But, who shall open and accept the tenders, should be clearly specified. At a rule, the lowest tender should be accepted and accordingly a decision be taken.
- 3. Placing an order:** After examining the terms of quotation if both parties accept, the purchase department should place an order. When order is placed it should be recorded in purchase order book and order should be signed by responsible officer.
- 4. Number of Copies of Purchase order to be prepared:** Purchase order should be prepared in triplicate (3 copies)
 - Original copy sent to supplier,
 - 1 copy to department requested for goods,
 - and other filed and kept in purchase department.
- 5. Number of Copies of Goods received note to be prepared:** On receipt of goods, stores department should prepare Goods received note in 3 copies
 - one copy to purchase department,
 - one copy to accounts department and
 - one to production control department.
- 6. Comparison:** Purchase department should compare goods received note with the purchase order.
- 7. Invoice checking:** Invoices are checked by a separate person called invoice clerk in purchase department to ensure prices charged and the quantity are correct.
- 8. Payment:** Invoice should be handed over to accounts department to make payments. Responsible official should draw cheque for payment of invoices. If any advance has paid to supplier against order, it should be deducted from the total amount and net amount should be paid.
- 9. In case of defective goods:** If any goods returned back, it should be recorded in purchase return book and supplier should be asked to send credit note. All incoming credit note should be numbered and filed.
- 10. Records:** Goods received should be entered in respective stores ledger and entries made in bin cards. (Printed cards used for accounting of stock of materials in stores).

INTERNAL AUDIT

Meaning: Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization to accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes.

According to WATTER B. MEIGS, "Internal auditing consists of continuous critical review of financial and operating activities by a staff of auditors functioning as full-time salaried employees."

OBJECTIVES OF INTERNAL AUDIT

1. To report on the effectiveness of the current internal control system and make suggestions on ways to make it better.
2. To confirm the authenticity, completeness, and accuracy of the financial accounting records given to management.
3. To aid in fraud's early detection and prevention.
4. To confirm that the organisation is complying to the standard accounting practises or the international accounting standards.
5. To make sure that the company's assets are appropriately protected and accounted for.
6. To make sure that the organisation is held accountable for its authentic, legal, and valid operations.
7. To verify if each organisational unit adheres to the policies and guidelines established by the top management.

ADVANTAGES OF INTERNAL AUDIT

1. More Effective Management: One of the biggest benefits of an internal audit is that it facilitates more effective management of the organization. The internal auditor will be able to point out any weaknesses of the organization in the operations or internal controls of the company. So, the management can use these insights to better the chances of achieving their goals.

2. On-going Review: The process of internal audit gives the organization a unique opportunity to conduct a review of the performances in the ongoing year itself. They do not have to wait for the end of the year to review the company's performance. This also means that if they are not on the correct path, this will help them change course and correct their mistakes immediately.

3. Performances of Staff Improve: **The** staff of the company remains alert and active. This is because there is the fear of their mistakes being caught by the internal auditor almost immediately. This will help improve their efficiency and performance. Also, they do not attempt to defraud the company for the same reasons. And on the other hand, it is a good morale booster for honest employees.

4. Ensures Optimum Use of Resources: **One** other benefit of the process of internal control is that it can be used as a tool to promote the optimization of resources. It will help point out the areas in which resources are being underutilized or wasted. And then these can be corrected. It will help control the costs and expenses of the company.

5. No Error and Fraud: The internal audit uses to protect accounting records from errors and fraud. Accounting and auditing go side by side when accounting work is over; the review will start. In situation errors and fraud committed by the accounting, staff will easily be detected and rectified.

6. Investigation: Internal audit is helpful to investigate the business matters. An internal auditor can ask to examine the facts and figures to confirm or clear any doubt in case of doubt. The internal auditor can investigate the matter in any manner.

7. Helps External Auditing: An internal auditor's work performance can help external auditors carry out the audit. The audit procedure of internal and external inspection is almost the same. The auditor can go through the internal audit report at the time of starting audit work. Anyhow external auditor is responsible for the external audit.

LIMITATIONS OF INTERNAL AUDIT

1. Shortage of Qualified Staff: The work of an audit requires years of study and experience. An inexperienced auditor can cause more damage than good. So usually, the company will find it somewhat difficult to find enough qualified staff members for the process of an internal audit.

2. Internal Reports are not accepted by Shareholders or tax authorities: Unlike a statutory audit, the findings of an internal audit are not published or made available to all. Internal audit's report is not accepted by either the shareholders or tax authorities, it is the external auditor report which is required to be submitted, their findings are only forwarded to the management.

3. **Biased:** Since internal audit is done by the employees of the company chances are that it may be biased(unfair) and therefore company cannot depend on such reports.

4. **Fails to detect planned frauds:** Since an internal audit is not done by the professional auditor chances of internal auditor not detecting the errors.

DIFFERENCE BETWEEN INTERNAL CHECK AND INTERNAL AUDIT

BASIS FOR COMPARISON	INTERNAL CHECK	INTERNAL AUDIT
Meaning	Internal Check is a system, wherein division of work and allocation of responsibilities are organized in such a manner that the work of one employee is spontaneously looked over by another.	Internal Audit is the ongoing critical examination of the financial and operational activities of the concern, by an internal auditor.
Method	Work of one person is automatically checked by another person.	Work performed by the employees is examined by a separate group.
Commencement of Work	Commences from the moment a transaction is entered.	Once the accounting process ends.
Involved evaluation of	Accounting and clerical accuracy	Effectiveness of management control
Performed by	Internal Check does not require separate staff. (Existing Staff)	A specially dedicated team of auditors
Cost Involvement	Economical	Comparatively Expensive
Purpose	Prevention of errors and frauds	Detection of errors and frauds
Tool for	Arrangement of the work	Examination of the work

Time of Checking	Checking is performed simultaneously when the work is performed.	Examination of the work takes place after the work is completed.
Report	Summary of day-to-day transactions acts as a report to the supervisor.	Submits his/her report to the management.

Assignment Questions

Two Marks Questions

1. Define internal control.
2. What is Internal Control?
3. Define Internal Check.
4. Write the meaning of internal check.
5. Write any two objectives of internal check.
6. Write any two features of internal check.
7. Mention any two principles of internal check.
8. Write any two limitations of internal check.
9. What do you mean by internal audit?
10. Write any two differences between internal check and internal audit.
11. Write any two objectives of internal audit.
12. Write any two advantages of internal audit.
13. Write any two disadvantages of internal audit.

Five Marks Questions

1. Discuss the objectives of internal control.
2. What are advantages and disadvantages of internal control?
3. Explain the objectives of internal check.
4. Explain the internal check as regard with wage payment.
5. What are disadvantages of internal audit?
6. Give the difference between internal check and internal audit.

Fifteen Marks Questions

1. Explain the advantages and disadvantages of internal control.
2. Illustrate the fundamental principles of internal check.
3. Discuss the internal check as regard with cash sales and cash purchases.
4. What are the advantages and disadvantages of internal audit?

